



BASIC FACTS:

Capital: Kiev
Area: 603.7 square kilometers
Population: 49,153,027 (July 2000 est.)
Currency: 1 hryvna = 100 kopiykas
Exchange Rate: \$1 = 5.44 Ukraine Hryvnia
GNP: US\$37.5 billion (1999)
GDP Growth: -1.9% (1998); -0.4 (1999); 2.5 (1999-03);
GNP per capita: US\$750 (1999)
Inflation: 19.2% (1999)

EXECUTIVE SUMMARY

Ukraine, a land of approximately 50 million people with substantial human, technical, and natural resources, is an important emerging market at the crossroads of Central Europe, Russia, Central Asia, and the Middle East and holds great potential for becoming an important new market for U.S. trade and investment. A significant number of both large multinationals and smaller foreign investors are present in this challenging market. Ukraine's ultimate trade and investment potential will depend largely on the success of its attempts to accelerate the movement toward a market economy and develop a more conducive business environment.

Although Ukraine is taking steps in adapting its trade regime to conform to the World Trade Organization's (WTO) accession requirements, which will have a positive effect for U.S. investors and exporters, progress is slow and it is difficult to assess when ultimate accession will occur.

The most pressing economic problems currently facing Ukraine are of a structural nature: slow privatization; little industrial restructuring; an unwieldy governmental apparatus; a narrow tax base; over-regulation; significant levels of corruption; and a largely unreformed agricultural sector. These factors have caused over half of the economy to operate in the informal "shadow" sector.

While foreign assistance is crucial in this period of economic transition, official flows of assistance in the longer term should be dwarfed by private capital flows if Ukraine creates a more conducive environment for private sector development. Ukraine requires technology, management expertise and access to international markets that only private business can provide. Projected flows of tens of billions of dollars over the next several decades are not unrealistic.

Over 200 U.S. companies are currently active in the Ukrainian market, and many are members of the American Chamber of Commerce based in Kyiv. The U.S. companies include leading U.S. multinationals such as Coke, McDonalds, P&G, Kodak, Westinghouse, Motorola, Oracle, Cisco, Cargill, KPMG, Citibank, and others. But also present are a number of small "niche market" investors involved in hotel management, construction, computer services, a newspaper, and even a bicycle messenger service. Conditions have continued to be very difficult for most companies, due to excessive bureaucracy, the difficulty of enforcing contracts, and rampant corruption, putting Ukraine near the bottom of Transparency International's listing. This is compounded by a vague, arbitrary and intrusive taxation system, along with extremely high tax rates for those honest enough to pay them.

As a result, a number of U.S. companies have departed from Ukraine over the past year. One notable example was the withdrawal of Bristol-Myers Squibb, who stated that "BMS Corporate has taken a strategic decision to back away from those markets not offering high enough profit potential and focus resources on higher performing markets." Also departing was CERES-Ukraine, a joint venture of CERES International (a sea port management company) with the Port of Odessa, for reasons of differing management style. However, this falling number of U.S. investors is being at least partially offset by a constant stream of newcomers to the market.

The administrative reform of the Government of Ukraine, although intended to result in more efficient and streamlined operations, has however had 'teething problems' as various parts of the bureaucracy were shifted and restructured. Some organizations, like the State Committee on Standards (Derzhstandard), have seen notable improvements in their operations. But others, like the former Ministry of Industrial Policy, now incorporated into the huge Ministry of Economy (MOE), are still finding their direction.

U.S. business could play a major role in providing capital investment and the know-how required to modernize and restructure Ukraine's economy, particularly in the above sectors. There is great potential in Ukraine, but U.S. businesses desiring to do business in the country must be prepared to deal with a very challenging environment. To maximize Ukraine's potential, the government of Ukraine will need to press ahead in its efforts to privatize its economy; develop a business climate that is conducive to the rapid expansion of U.S. trade and investment (including extensive deregulation); limit tariff and non-tariff barriers to U.S. trade and investment; ensure fair access to the Ukrainian market for U.S. firms; increase awareness of U.S. business, products, and technology in Ukraine; and increase the U.S. business community's awareness of the market in Ukraine, as well as its needs and existing trade and investment opportunities. U.S. companies seeking to enter the Ukrainian market must be prepared for numerous challenges.

ECONOMIC OUTLOOK

Ukraine was deeply integrated into the former Soviet economy, particularly in the agricultural and defense industries. Upon achieving independence, many analysts believed Ukraine had the best medium-term prospects for economic development of any of the former Soviet republics, including Russia. Ukraine's vast agricultural resources, port and shipbuilding facilities, machinery sector, transportation network, and skilled workforce created a favorable investment picture. Ukrainian authorities, however, were unwilling to undertake serious economic reform. In 1993, for example, annual inflation ran 10,000%, privatization was at a standstill, real wages plummeted, and economic output continued its steep decline.

After assuming office in July 1994 (and again in 1999), the Kuchma government announced the pursuit of a more serious program of economic reform, though pursuit of reforms has been uneven. Reforms led to a Systematic Transformation Facility (STF) with the International Monetary Fund (IMF) in 1994, to IMF Standby Agreements which functioned during parts of 1995-1997 and early 1998, and to a three-year IMF Extended Fund Facility (EFF) in September 1998. Ukraine has also received disbursements under major World Bank sectoral loans in areas such as financial sector development, privatization, agriculture, and energy.

Perhaps no other country in the former Soviet Union (FSU) region has experienced such a large gap between economic performance and potential as Ukraine. Endowed with good natural resources, superb agricultural land, a well-educated population, ethnic peace, and a strategic location in Europe, Ukraine was positioned to be one of the most successful of the former Soviet states in attracting the foreign investment needed to restructure its economy.

Yet with a current annual GDP of \$530 per capita, Ukraine has one of the lowest levels of income in the FSU. The U.S., with some \$589 million out of total investment of \$3.2 billion, is the single largest source of foreign investment in Ukraine. These figures have both remained static for several years and are very small for a country of more than 50 million people with the resource base and economic potential of Ukraine. (By way of contrast, the corresponding figures in Poland, a country of 40 million people, are \$6 billion U.S. investment out of \$30 billion total foreign investment – i.e. Poland has 10 times more foreign investment than Ukraine.)

The IMF, the World Bank, the United States, and other donors have consistently delivered the same message to Ukraine during the past five years: market economics can only be successful in Ukraine if the government reduces its role in the economy, and gives freer rein to private enterprise. If this happens, we may see foreign investment rise again, and with rising investments will come growth of GDP.

Much U.S. assistance has been focused on helping Ukraine reform its economy and governing institutions. Making improvements in the climate for investment and opening up Ukrainian markets are crucial to success.

The USG is concerned, however, about U.S. investor problems that remain unresolved, and more generally about Ukraine's poor investment climate and slow pace of economic reform. In addition to seeking resolution of investment disputes, the USG has urged the government of Ukraine to take specific steps to improve its investment climate. These include instituting more transparent procurement and licensing requirements, implementing regulatory reform, improving protection of shareholder rights, improving enforcement of judicial decisions, and enforcing a strong code of ethics.

Ukraine has a reputation as a difficult place to do business. In its Corruption Perceptions survey of 85 countries, Transparency International ranked Ukraine near the bottom. Corruption is a major obstacle to genuine reform and long-term recovery in Ukraine.

BUSINESS AND INVESTMENT CLIMATE

The Ukrainian government officially claims that it is actively interested in creating a free market economy and openly seeks foreign investment. However, Ukraine is struggling through its transition, has been slow in implementing much-needed reforms, and has so far failed to establish an investment climate that encourages business and investment.

Although the Ukrainian government wants foreign investment, it has had difficulty adopting and implementing legislation that would encourage it. It passed a Foreign Investment Law in April 1996, which guaranteed registered foreign investors equal treatment with local companies and possible special privileges for investors. Furthermore, the law provided certain protections, including general guarantees against expropriation, unhindered transfer of profits and post-tax revenues, and a ten-year guarantee against changes in legislation that affect these basic protections. However, certain of its provisions, in particular, a tax holiday, were subsequently suspended by Parliament, thus damping the inflow of foreign capital.

Despite these efforts, a new survey conducted by the International Finance Corporation (IFC) found that most small businesses feel that government authorities have a hostile attitude toward entrepreneurial activity, and that tax and other inspections are excessive.

Privatization officially started in 1992 with the establishment of the State Property Fund. Privatization met strong bureaucratic and parliamentary resistance and was suspended in 1994. A presidential decree in November 1994 instituted a new voucher-based mass privatization program (MPP). Prior to 1995, 1,200 medium to large enterprises were privatized through an employee lease-buyout program, whereby employees' leases were converted to ownership. Beginning in 1996, voucher sales began for medium and large industrial enterprises. Usually, 20% of the shares in an enterprise were sold on a preferential basis to employees, 20% were sold to the public in exchange for privatization certificates, and the remaining

shares were then sold for cash. There was no restriction on foreign ownership. In a limited number of cases involving "strategic enterprises," the state retained 26-51% ownership.

In 1998, the government planned to raise UAH 1.04 billion (approximately \$ 270 million) through cash privatization, but eventually only raised UAH 340 million (\$ 80 million). Overpriced shares, the failure to offer majority shareholdings to investors, and onerous investment obligations accompanying the share packages are all contributing to low privatization revenue. Nevertheless, more than ninety percent of all medium and large enterprises have been privatized to date - 9,500 out of 10,000. These private enterprises account for 62% of Ukraine's industrial production and 50% of Ukraine's industrial employment.

To date, management/employee purchases remain the most popular form of privatization, with the majority of shares in medium and large enterprises held by employees and the public. However, most of these newly privatized enterprises are not easily restructured: their ownership is too diffuse; their shares are not actively traded in the secondary market, discouraging further investors from buying; and, in some cases, the government retains a 25%-plus-one block of shares, permitting it to block restructuring if it chooses. As a result, these enterprises continue to suffer from a lack of investment capital. Those few that are restructuring are among the most attractive firms, and they are just beginning the process.

Foreign investors are not particularly discriminated against at any stage of the privatization process. The procedures for conducting tenders were designed to attract strategic investors (language in the 1999 privatization program implies equal treatment of all parties, especially foreign investment). The overall rules are the same for foreigners and locals. Cash auctions must go through a local institution, but it is not difficult to find a broker to represent foreign investors. From the start of the privatization process up to the purchase a level playing field exists. However, while Ukraine's written privatization laws and regulations are not perfect, many believe that corporate governance issues (unfair treatment by company management toward all outside investors -- foreign and domestic -- who have not come to terms with management) are a major impediment to the success of privatization and enterprise restructuring in Ukraine.

Although the government has reduced many subsidies to state-owned industries, they still remain quite significant. For the most part, these subsidies appear not to be specifically designed to provide direct or indirect support for exports, but rather to maintain full employment and production. The government does not target export subsidies specifically to small business. In conjunction with its application to join the World Trade Organization, Ukraine is negotiating to join the WTO Subsidies Code.

Corruption

Corruption pervades all levels of government, according to press reports and foreign business complaints. Some corrupt acts have been criminally prosecuted, but many more that have been exposed have resulted in little or no action. Many anticorruption campaigns appear to be politically or economically motivated. There

is little evidence of a consistent anti-corruption effort by Ukrainian law enforcement agencies.

Corruption permeates much of Ukraine's court system, police, civil service and regulatory system. Conflict of interest is a poorly developed concept, and many officials and bureaucrats retain commercial interests while in power. For example, Rada members continue to own businesses while serving on the Rada committees responsible for regulating those businesses. Corruption can also be institutional, to the extent that certain government entities may own or have close ties to businesses that compete with those that they regulate. Government entities also use means that are off the balance sheet to pay for operations and expenses not funded by the state budget. A complicated and non-transparent regulatory system has also encouraged petty corruption at all levels of government. Development of a professional administrative corps is hampered by the low salaries of such professionals. (For example, even Rada members and judges receive official salaries of less than \$300 per month.)

POLITICAL CLIMATE

The course of political reform was reinforced with the Ukrainian Parliament's June 28, 1996 passage of a new Constitution. The new Constitution recognizes the right to private ownership of land and property. It also strengthens provisions on the rule-of-law and provides for a more independent judiciary, promising more effective legal protections for investors. It could also help facilitate passage of a long-delayed new Civil Code, which contains a Western-style commercial code.

The principles expressed in the Constitution, while laying the groundwork for market-economy reforms, have not yet been fully put into practice. A lack of legislation in many areas of economic activity, as well as the absence of a reliable system to enforce existing legislation, are obstacles to achieving an investment climate that will attract substantial foreign investment. Key questions such as land ownership, land purchase by foreigners, privatization conditions, and taxation reform remain unresolved.

Increasing corruption and crime is a significant factor inhibiting legitimate business activity and foreign investment in Ukraine. President Kuchma has declared the fight against organized crime to be one of the top priorities of his administration, but up to this point little real progress has been made.

There is a broad understanding of these problems within Ukrainian official circles and a general consensus among reformers on the need to ensure that foreign investors are greeted with a more favorable legal and regulatory climate in the future. The hard work of translating that consensus into law is one of the most important challenges facing the Ukrainian political system today. Ensuring that these laws are effectively executed is an equally great challenge.

Ukrainian-Russian economic relations will likely continue to influence the larger

investment picture in Ukraine. Areas of particular strain involve energy supplies and gas transit. Concern also exists about possible Russian attempts to exert economic pressure on Ukraine, particularly in the trade area.

The recent political crisis in Ukraine, however, may have a negative impact on the investment climate in the country. In April 2001, President Kuchma orchestrated the ousting of Prime Minister Viktor Yushchenko from Parliament. This political conflict occurred as the Ukrainian opposition demanded the ousting of President Kuchma and top state officials over their alleged role in the murder of independent journalist Heorhiy Gongadze. These allegations seemed to be confirmed by secret audio recordings of some of Kuchma's conversations that were made public. Many in the Ukrainian opposition assert that Kuchma ordered the arrest of former Deputy Premier Yulia Tymoshenko and orchestrated the dismissal of Yushchenko in an attempt to gradually change the direction of protest actions. It also appears that the Communists and the so-called oligarchic parties aided Kuchma in ousting Yushchenko in exchange for some promised concessions. In the aftermath of the political crisis, Kuchma appears to have managed to tighten his control of the government.

SOURCES OF FINANCING

The Ukrainian banking system consists of the central bank - the National Bank of Ukraine (NBU), and commercial banks of various classifications. The NBU is responsible for monetary circulation, registration of commercial banks and oversight of their activities, and sometimes intervenes in the currency market to moderate changes in the exchange rate. As of January 1, 2000, 203 banks were registered in Ukraine, including 30 with foreign capital backing, and 9 with 100% foreign capital. Of the total 203 banks registered, 165 banks are actually operating. With the exception of two state-owned banks, Oshchadbank and Ukreximbank, the banks are all either joint-stock companies (JSC) (124 open JSC, 49 closed JSC) or limited liability companies (28).

Seven banks, whose net assets exceed UAH 1 billion, control much of the capital and political power in Ukraine: Prominvest Bank, Privatbank, Bank Ukrayina, Aval, Ukreximbank, Ukrsotsbank, and Oshchadbank. The substantial capital base of these banks guarantees their stability. However, these seven banks also have the highest percentage (27%) of problem loans in their credit portfolios (mainly to state-owned enterprises, which amount to dead weight on the banks' balance sheets). The average percentage of "problem loans" in the Ukrainian banking system is calculated at 20%.

Ukraine's payment system is reliable. All domestic payments - irrespective of the amount - are carried out fully electronically through the clearing center and the 42 branches of the NBU. The average time for payment transfer is between ten minutes and two hours. The transfer of payment orders in foreign currencies is made either through a cover at the foreign partner-bank, or through the NBU's international settlements department.

Ukraine has adhered to a number of international legal instruments pertaining to international payments via checks, bills of exchange, letters of credit, and collection arrangements. The safest method of receiving payment for U.S. exports is through an irrevocable letter of credit (L/C). To carry out hard currency transactions, a bank has to be authorized by the NBU. Authorized Ukrainian commercial banks are members of SWIFT (Society for Worldwide Inter-bank Financial Telecommunications).

TELECOMMUNICATIONS SECTOR

Fixed Line Operators

Ukrtelecom, the government owned fixed line operator in Ukraine, was created in 1993, when the Ukrainian Ministry of Communications reorganized the national telecommunications structure by merging several telecom departments and regional companies into the Ukrainian State Telecommunications Corporation (Ukrtelecom). Owning all transmission facilities, Ukrtelecom administers the national wire line infrastructure.

Ukrtelecom has an installed capacity of 8.9 million numbers with 8.5 million numbers operational. The company's existing wire-line network is far from optimal, however, with fees for line installation reaching \$1,000 after a substantial waiting period. Although there is increased use of digital equipment in the network, many regional switches continue to connect customers with outdated equipment. Digital exchanges serve only about 10% of customers, while electronic and quasi-electronic exchanges server another 10%. The remaining switching gear consists of obsolete relay and mechanical equipment that severely limits the introduction of a new electronic billing system. As a result, many users outside urban areas now pay a symbolic fee of up to \$3 per month. Automated billing systems have only been introduced on a limited basis in urban centers. In some small towns and villages there are instances where only one line exists for several thousand people and the wait for a line can exceed 10 years. In cases where rural wireless local loops are utilized, they are unprofitable. Ukrtelecom subsidizes those local loops with revenues from inflated fees for international calls, line installation, and registration.

Teledensity varies dramatically by region with Kyiv exhibiting the highest telephone penetration at 43.6%, followed by the industrial regions in the east of the country at 19%. Telephone lines in the agricultural regions of Transcarpathia and Carpathia in the agricultural west of the country are relatively rare. The average teledensity for the country is 19.8 telephones per 100 inhabitants. The annual per capita spending for telecom services in Ukraine is \$20.6. According to the Commercial Section of the U.S. Embassy in Kyiv, 3.3 million people are on the waiting list for private phone service. There is an excess capacity, however, of several hundred thousand circuits available in part because potential subscribers cannot afford to become connected.

Recent advances in wire-line communications include the completion of a national telecom network with 45 long-distance exchanges (27 are digital and located in

regional centers, while the other 18 regional exchanges are analog) and three digital international gateways. Ukraine has also installed a national fiber optics network connected to the international fiber optic system such as ITUR, TEL, TAE, and BSFOCS. The fiber optic network consists of 4,200 km of fiber and digital microwave communication lines. Currently, this network is expanding towards the neighboring regions of Russia. Ukrainian users now have available international telephone connections to more than 200 countries.

Two companies dominate the national and long-distance wire-line networks: Ukrtelecom and Utel. There are a number of other providers of wire-line services (e.g. Golden Telecom Business Solutions, Kancom/Andrew, Optima, Farlep, Lyuza, Intersvyaz, Crymtel, and Telecominvest), but their total number of customers does not exceed 120,000, thereby making their share of the local market insignificant.

Wireless Communication

Mobile Communication (MC) users in Ukraine have almost doubled from September 2000 to February 2001, and their number is approaching 1 million users. MC providers anticipate that by the end of 2001 the number of MC customers may reach 1.7-2 million. The Industry also speculates that new growth of MC users will still not generate adequate revenues for operators to repay the funds they have already invested into upgrading their networks. In the meantime, current network capacity is approaching its technological limits.

Wireless mobile communications is the most active subsector of the telecom industry in Ukraine, in terms of user growth (market penetration for MC is only 2%, but the number of users has doubled every year). A striking feature of the market is the large number of MC operators. Five operators UMC, Kiev Star, Golden Telecom GSM, DCC, Welcom - offer wireless mobile services in the following standards: GSM900/1800 (UMC, Kiev Star, Welcom), NMTi 450 (UMC), DCS 1800 (Golden Telecom GSM), and D-AMPS (DCC).

Last year (2000), the market started to consolidate around two leading operators: UMC (Ukrainian Mobile Communications) and Kiev Star. UMC had 285,000 users in September 2000 (compared to 186,000 in March 2000). Kiev Star had 185,000 users in September 2000 (compared to 60,000 in March 2000). Based on information provided by MC operators, in November of 2000, there were only 600,000 MC users in Ukraine. But aggressive marketing and promotions, along with significant discounts in fees and the introduction of flexible payment schedules, have increased the number of users dramatically. The number of MC users nation-wide doubled from September 2000 to February 2001, and is now approaching 1 million users.

More than 80% of MC customers are accounted for by just two operators: UMC and Kiev Star. Industry insiders speculate that the other two remaining MC operators are considering divesting their networks, which would additionally consolidate the market. The industry believes that growth in the number of MC users was achieved by raising dealer fees being offered by the leading MC providers.

The dramatic success of operators in increasing the number of MC users, has disclosed some hidden problems:

No Spectrum Expansion: The leaders in the MC operators race did not anticipate such rapid growth in the number of customers. The GSM900 spectrum that these operators utilize does not provide room for an increase in traffic. Though a "spectrum expansion" was announced in 2000, operators still had not expanded into the GSM1800 spectrum as of January 2001.

Not Enough Profit to Support Upgrades: Another unforeseen problem is that new users do not generate enough revenues for operators to recoup funds already invested into the networks. And yet, additional investments are needed to upgrade network capacity to GSM1800. This situation leaves operators unable to finance upgrades out of current fees.

Network Capacity Approaching Technological Limits. Customers of a leading provider complain that the quality of the connection is diminishing. The industry speculates that the provider in question recruited more customers than the network can handle. Fueling the problem, new MC customers prefer prepaid card packages and utilize the mobile phone as an emergency communications system, which has impacted network capacity but does not generate new revenue growth. To keep the market developing, MC operators will need to find new investors and reduce low profit clients.

INFORMATION TECHNOLOGY SECTOR

The exact size and structure of the Ukrainian computer hardware market is difficult to measure, since official statistics ignore such key factors as local production, and shadow imports of components. However, local production based on imported components is thriving and reshaping the market. Based on data provided by market insiders, rate of importation of finished (assembled) "brand name" computer equipment has been decreasing by 10 percent annually, and importation of "non-brand name" computer equipment has been decreasing by 15 percent per year. This decline in imports of finished computers (both brand and non-brand) is mostly due to higher rate of taxation of imported finished PCs versus imported components. At the same time, demand for locally manufactured computer hardware (i.e. from imported components) is steadily increasing, and reached 75 % of total market share in the year 2000.

Of the approximately 700 companies currently operating on the local computer market, 66 are engaged in local assembly or manufacturing of PCs. 80% of these computers are Intel based. Due to higher rate of taxation of imported finished PCs versus imported components, local production using imported components is thriving and reshaping the market. The other 634 companies focus on distributorship, resales, system integration, computer upgrades and sales of peripherals. Industry experts estimate that only 10-15 percent of Ukraine's potential computer hardware demand has been tapped. The key problem is the

lack of purchasing power of consumers, plus the lack of consumer credit for installment purchases.

The market trends are as follows:

- A. Falling prices for expensive PCs (\$1,500-\$3,000) versus 10-20 percent increase in prices for low-end equipment (\$1,000)
- B. A growing interest in units with limited memory (64 Mbit or lower);
- C. Focus by local computer manufacturers on computer solutions, rather than on hardware sales;
- D. Decreasing share of desktop systems, and increasing sales of portable systems and servers.

Brand-name recognition of major U.S. computer manufacturers is strong, but pricing is still the key consideration for the Ukrainian purchaser. Major local companies sell between 10,000 to 20,000 PCs annually. Although increasing rapidly, home use of PCs is still limited to 10-15% of computer users. U.S. companies can access the Ukrainian market by tapping into an increasingly sophisticated network of agents and distributors throughout Ukraine who are able to reach a wide range of clients.